

The Congressional Budget Resolution and the Economic Effects of Balancing the Budget

The budget resolution adopted by the Congress earlier this summer proposes a dramatic change in fiscal policy that would lead to a balanced budget in 2002. It calls for reducing deficits over the 1996-2002 period by about \$1.25 trillion compared with the Congressional Budget Office's projections under current policy. This change in policy is not reflected in the baseline economic and budget projections detailed in Chapters 1 and 2. Although the Congress has adopted the budget resolution, it has not completed action on the legislation needed to implement the plan--to provide appropriations for 1996, set new statutory caps to limit future appropriations to the levels assumed by the resolution, and make the changes in the laws governing mandatory programs to reduce spending for those programs.

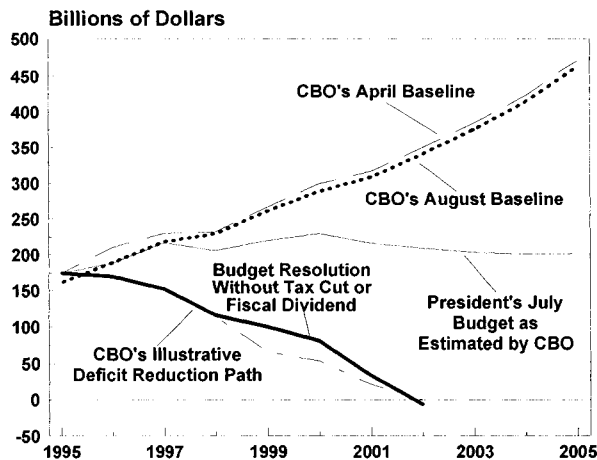
If the implementing legislation is enacted this fall as the budget resolution assumes, CBO's winter 1996 baseline budget projections will be dramatically different from those presented in Chapter 2. CBO believes that enacting legislation that puts the government on a credible path to a balanced budget by 2002 will also affect the economy. The economic effects of balancing the budget are likely to be similar to the reduction in interest rates and the slight increase in real growth that CBO detailed in Appendix B of its April 1995 report *An Analysis of the President's Budgetary Proposals for Fiscal Year 1996*. They would lower federal interest costs and increase revenues by an estimated \$50 billion in 2002 and a total of \$170 billion in 1996 through 2002. Those savings have been referred to as a fiscal dividend.

The budget resolution also assumes a significant tax cut, although the effects of the tax cut are not reflected in the revenue totals stated in the resolution. The resolution establishes a procedure that will allow a tax cut totaling \$50 billion in 2002 and \$245 billion over the 1996-2002 period if CBO certifies that reconciliation legislation, which is intended to implement the changes in mandatory spending and revenues assumed in the budget plan, produces the savings required to balance the budget in 2002.

The Budget Resolution

CBO projects that the deficit will grow to nearly \$350 billion in 2002 under current policies, assuming that discretionary spending after 1998 equals the level of the statutory cap for 1998 adjusted for inflation. In contrast, the budget resolution represents a seven-year plan to balance the budget (see Figure 12). Since the budget resolution is based on economic and technical assumptions that are largely the same as those CBO used in its baseline projections in April 1995, the budget resolution assumes that significant changes in policy are required to achieve a balanced budget by 2002. (Because the budget resolution is based on the April projections and because there is little difference for most years between CBO's April projections and the projections described in Chapter 2 of this report, this chapter uses the April baseline as the starting point for describing the budget resolution and its effects.)

Figure 12.
Comparison of Projected Deficits (By fiscal year)



SOURCE: Congressional Budget Office.

The resolution proposes to balance the budget in 2002 by reducing discretionary spending in that year about \$30 billion below the 1995 nominal level (\$121 billion below CBO's baseline level) and by making changes in mandatory programs (particularly Medicare and Medicaid) that would reduce spending \$161 billion below the level projected for 2002 under current policy. Those savings, along with proposed savings in the preceding years, would reduce the government's costs of servicing the debt by \$66 billion in 2002.

The resolution also allows the Congress to consider a large tax cut if CBO certifies that the legislation implementing the budget resolution would achieve a balanced budget in 2002. Because the effects of the tax cut are not reflected in the revenue levels of the resolution, the tax cut would increase the deficits stated in the resolution. However, the fiscal dividend from balancing the budget also is not reflected in the resolution totals. The effects of that dividend would fully offset the planned tax cut in 2002 and would partially offset it in the earlier years covered by the budget resolution.

Baseline Assumptions of the Budget Resolution

As is the case with almost any budget plan, the starting point for developing the budget resolution is a

projection of the spending, revenues, and deficit under current policies. Such a starting point allows participants in the budget process to consider the appropriate changes in policy. If a particular outcome--such as a balanced budget--is desired, the baseline projections indicate how much of a change is needed to reach that goal.

Baseline projections of discretionary spending are both more ambiguous and less important than baseline projections of mandatory spending and revenues. Discretionary spending is determined by the amount appropriated in legislation enacted each year. With minor exceptions, current laws do not provide discretionary appropriations for 1996 or any subsequent year. Thus, it is not clear what current policy is regarding spending in those years.

This ambiguity allows different interpretations of current-policy baselines for discretionary spending. For example, the baseline used by the Senate Committee on the Budget assumed that appropriations for nondefense accounts in 1996 through 2002 would be the same as in 1995 but that appropriations for defense accounts would equal President Clinton's February 1994 budget request (adjusted to reflect actual appropriations for 1995). In describing the discretionary spending in the budget resolution, the House Committee on the Budget compared the levels recommended for 1996 through 2002 with estimated spending in 1995. In contrast, the CBO baseline discussed in this chapter assumes that discretionary spending will equal the statutory limits that apply through 1998 and will increase at the rate of inflation after 1998.

Because setting the policy for discretionary spending in future years simply requires determining the amount to be appropriated in those years, agreeing on a discretionary baseline is not crucial to reaching agreement on the policy or defining it. In the end, the specified level of discretionary spending represents the same policy whether it is described as a cut from an inflated baseline or an increase above zero funding. The difference between CBO's baseline with discretionary inflation after 1998 and the baseline for discretionary spending used by the budget committees does not reflect any difference in economic or technical assumptions, and the difference is therefore not included in the baseline adjustments in

Table 14. However, the difference between CBO's baseline and the discretionary spending proposed in the resolution is separated into the effects from freezing discretionary spending at the 1995 appropriated level and the additional cuts required to reach the levels specified in the resolution.

In contrast to the process that determines discretionary spending, laws currently in place will determine mandatory spending and revenues in future years if no new legislation is enacted. Laws governing mandatory programs usually define who is eligible for benefits and set rules that determine the amount to be paid to beneficiaries based on their characteristics such as age, income, or contributions paid into the program fund. Revenues are governed by laws defining the taxes to be paid on certain types of income or on certain transactions. Current policy for mandatory programs and revenues simply means the eligibility rules, benefit levels, and tax rules specified in current laws. Most analysts agree on what those laws provide. But the level of mandatory spending and revenues projected under those laws depends on assumptions about the number of people who will be eligible, their characteristics, the level of taxable income that will be reached, and a host of other factors referred to as economic and technical assumptions.

Economic and technical assumptions can have a major impact on the baseline projections of mandatory spending and revenues, and in turn, those projections can have a major impact on policy proposals and decisions. For instance, the President has presented proposals in his July 31 *Mid-Session Review of the 1996 Budget* that are intended to lead to a balanced budget by 2004. The economic and technical assumptions in the Administration's baseline are slightly more optimistic than CBO's, as discussed in Chapter 2. Because the cumulative effect of those differences reduces the baseline deficits estimated by the Administration (spending is lower and revenues are higher) compared with CBO's projections, the deficit reduction proposed by the President is significantly smaller than the budget resolution calls for. Using CBO's economic and technical assumptions, the President's proposals would result in deficits that hover around \$200 billion from 2002 through 2005 (see Figure 12 and testimony by the Director of CBO

before the House Committee on the Budget on August 3, 1995).

The budget resolution, however, is essentially based on CBO's economic and technical assumptions; the mandatory spending and revenue baseline used in developing the budget resolution is largely the same as CBO's April 1995 baseline. The most significant adjustment to that baseline results from assuming that annual increases in the consumer price index will be 0.2 percentage points lower starting in calendar year 1998 than CBO's baseline had assumed. That adjustment reflects CBO's estimate that its baseline economic projections, which were completed in December 1994, understated the reduction in the reported CPI that is likely to result when the Bureau of Labor Statistics rebenchmarks the CPI in 1998. As shown in Table 14, the CPI adjustment, which lowers mandatory spending and raises revenues, reduces the baseline projection of the deficit in 2002 by \$9 billion.

The budget resolution's baseline was also adjusted to account for a change in the method of calculating the subsidy costs of direct student loans. The resolution requires that estimates made for purposes of the Congressional Budget Act include the costs of administering the direct student loan program in the subsidy costs of the loans. Recalculating the subsidies of direct loans increased the projected baseline cost of the student loan program by almost \$1 billion in 2002.

The only other significant adjustment dealt with excise taxes on oil and chemical feedstock that are dedicated to Superfund and are scheduled to expire in December 1995. CBO's baseline follows the baseline rules for revenues set forth in section 257(b) of the Balanced Budget and Emergency Deficit Control Act of 1985, as amended, and assumes that expiring excise taxes that are dedicated to a trust fund will be extended at current rates. The budget resolution's baseline assumes that the Superfund taxes will expire as provided under current law, reducing baseline revenues by less than \$1 billion in 2002.

The budget resolution also assumes that balancing the budget will produce lower interest rates and a slightly higher rate of economic growth than the

Table 14.
Changes in the Budget Resolution from CBO's April Baseline (By fiscal year, in billions of dollars)

	1996	1997	1998	1999	2000	2001	2002	Total, 1996-2002
CBO April Baseline Deficit ^a	210	230	232	266	299	316	349	*
Baseline Adjustments ^b								
CPI rebenchmarking ^c	0	0	0	-1	-3	-6	-9	-18
Other adjustments	<u>1</u>	<u>1</u>	<u>1</u>	<u>2</u>	<u>2</u>	<u>1</u>	<u>1</u>	<u>10</u>
Total ^c	1	1	1	1	-1	-4	-8	-9
Policy Changes								
Outlays								
Discretionary								
Freeze ^d	-8	-9	-12	-35	-55	-75	-96	-289
Additional savings	<u>-10</u>	<u>-21</u>	<u>-27</u>	<u>-24</u>	<u>-20</u>	<u>-24</u>	<u>-25</u>	<u>-151</u>
Subtotal	-18	-29	-39	-59	-75	-99	-121	-440
Mandatory								
Medicare	-8	-18	-27	-37	-49	-60	-71	-270
Medicaid	-4	-8	-16	-24	-33	-43	-54	-182
Other	<u>-10</u>	<u>-19</u>	<u>-25</u>	<u>-26</u>	<u>-29</u>	<u>-30</u>	<u>-36</u>	<u>-175</u>
Subtotal	-22	-45	-67	-87	-111	-133	-161	-626
Net interest	<u>-1</u>	<u>-5</u>	<u>-11</u>	<u>-20</u>	<u>-31</u>	<u>-47</u>	<u>-66</u>	<u>-181</u>
Total Outlays	-41	-79	-117	-167	-217	-278	-348	-1,247
Revenues ^e	<u>e</u>	<u>e</u>	<u>e</u>	<u>e</u>	<u>e</u>	<u>e</u>	<u>e</u>	<u>-1</u>
Total Policy Changes	-41	-79	-117	-167	-218	-278	-348	-1,248
Total Adjustments and Policy Changes	-40	-78	-116	-166	-219	-283	-356	-1,257
Budget Resolution Deficit	170	152	116	100	81	33	-6	*

SOURCE: Congressional Budget Office based on U.S. House of Representatives, *Concurrent Resolution on the Budget for Fiscal Year 1996*, Conference Report 104-159, to accompany H. Con. Res. 67 (June 26, 1995).

NOTE: * = not applicable; CPI = consumer price index.

a. Projections assume that discretionary spending is equal to the spending limits that are in effect through 1998 and grows at the rate of inflation after that.

b. Adjustments are to projections of mandatory spending and revenues only.

c. Revenue increases are shown as negative because they reduce the deficit.

d. Savings from freezing 1996-2002 appropriations at the nominal level appropriated for 1995.

e. Less than \$500 million.

CBO baseline assumes. The resulting fiscal dividend, however, is not reflected in the resolution's baseline or in the outlay, revenue, and deficit totals stated in the resolution (see Table 15).

Policy Proposals

The budget resolution assumes that very substantial changes in policy are required to balance the budget in 2002. It sets stringent limits on appropriations for fiscal years 1996 through 2002. Under those limits, defense outlays will be almost the same in 2002 as the \$269 billion that CBO estimates will be paid out in 1995 and only slightly higher than the outlays that would result from freezing appropriations at the 1995 level (see Table 16). Outlays for defense in 2002 under the budget resolution are about \$54 billion, or 17 percent, below the spending needed to keep pace with inflation. Planned nondefense spending in 2002

is about \$30 billion lower than projected outlays in 1995. That represents more than a 30 percent reduction in real (inflation-adjusted) terms. By 2002, the real buying power of total (defense and nondefense) discretionary spending will be almost one-quarter lower than it is today.

While drafting the budget resolution, the budget committees discussed various ways to keep appropriations within the strict limits assumed by the resolution, but the final decisions about funding for particular programs will be made by the appropriations committees and the full House and Senate during consideration of appropriation bills over the 1996-2002 period. Because deeper cuts in real terms are required in each succeeding year, hard choices will have to be made every year through 2002 in order to comply with the plan set out in this year's budget resolution.

Table 15.
Budget Resolution Outlays, Revenues, and Deficits (By fiscal year, in billions of dollars)

	1996	1997	1998	1999	2000	2001	2002
Outlays							
Discretionary	534	524	518	516	520	516	515
Mandatory							
Social Security	352	371	391	411	433	456	480
Medicare	171	180	189	200	212	227	244
Medicaid	96	102	106	110	115	119	124
Other	<u>177</u>	<u>184</u>	<u>188</u>	<u>203</u>	<u>216</u>	<u>221</u>	<u>230</u>
Subtotal	795	837	874	925	976	1,023	1,078
Net interest	259	266	270	276	282	283	284
Total Outlays	1,588	1,627	1,661	1,718	1,778	1,822	1,876
Revenues	1,417	1,475	1,546	1,618	1,697	1,789	1,883
Deficit	170	152	116	100	81	33	-6

SOURCE: Congressional Budget Office based on U.S. House of Representatives, *Concurrent Resolution on the Budget for Fiscal Year 1996*, Conference Report 104-159, to accompany H. Con. Res. 67 (June 26, 1995).

NOTE: Neither the effects of the contingent tax cut anticipated by the budget resolution nor the fiscal dividend expected to result from balancing the budget are reflected in these figures.

Table 16.
Discretionary Outlay Savings in the Budget Resolution (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000	2001	2002
Savings from CBO Baseline with Inflation								
Appropriations at the 1995 Level Adjusted for Inflation								
Defense	269	270	278	285	295	304	315	325
Nondefense	<u>277</u>	<u>286</u>	<u>296</u>	<u>307</u>	<u>319</u>	<u>331</u>	<u>342</u>	<u>354</u>
Total	546	556	574	592	613	635	657	679
Budget Resolution								
Defense	*	264	266	265	268	272	271	271
Nondefense	<u>*</u>	<u>270</u>	<u>258</u>	<u>253</u>	<u>248</u>	<u>249</u>	<u>246</u>	<u>244</u>
Total	*	534	524	518	516	520	516	515
Budget Resolution Minus Baseline with Inflation								
Defense	*	-6	-12	-20	-27	-33	-44	-54
Nondefense	<u>*</u>	<u>-16</u>	<u>-38</u>	<u>-54</u>	<u>-70</u>	<u>-82</u>	<u>-96</u>	<u>-109</u>
Total	*	-22	-50	-74	-97	-115	-140	-164
Savings from CBO Baseline Without Inflation								
Appropriations Frozen at the 1995 Dollar Level								
Defense	269	264	264	264	264	264	264	264
Nondefense	<u>277</u>	<u>280</u>	<u>281</u>	<u>281</u>	<u>277</u>	<u>276</u>	<u>276</u>	<u>276</u>
Total	546	544	545	545	540	540	540	540
Budget Resolution								
Defense	*	264	266	265	268	272	271	271
Nondefense	<u>*</u>	<u>270</u>	<u>258</u>	<u>253</u>	<u>248</u>	<u>249</u>	<u>246</u>	<u>244</u>
Total	*	534	524	518	516	520	516	515
Budget Resolution Minus Baseline Without Inflation								
Defense	*	0	2	1	4	8	7	7
Nondefense	<u>*</u>	<u>-10</u>	<u>-23</u>	<u>-28</u>	<u>-29</u>	<u>-28</u>	<u>-31</u>	<u>-32</u>
Total	*	-10	-21	-27	-24	-20	-24	-25

SOURCE: Congressional Budget Office.

NOTES: Nondefense amounts include Violent Crime Reduction Trust Fund spending.

* = not applicable.

The planned level of discretionary spending in 2002 represents savings of \$121 billion compared with CBO's baseline projection that assumes compliance with the discretionary caps and an inflation adjustment for discretionary spending after 1998 (see Table 14).¹ To reach a balanced budget in 2002, the budget resolution also calls for changes in mandatory programs that would save a total of \$161 billion in that year. The budget resolution divides responsibility for achieving those savings among 11 Senate and 12 House committees. The committees are instructed to submit legislation to achieve the required savings to the budget committees of their respective Houses no later than September 22. The budget committees will then package the legislation submitted by all of the committees into an omnibus reconciliation bill.

The conferees on the budget resolution made certain assumptions about which programs would be cut in order to determine the level of savings to assign to each committee. However, the committees are not bound by those assumptions; they may achieve the required savings through any combination of cuts in programs within their jurisdiction. Nevertheless, the assumptions behind the budget resolution indicate the likely cuts in various programs. The budget committees have not provided a full description of their assumptions, but they have indicated that savings in the Medicare and Medicaid programs represent \$125 billion (more than three-quarters) of the assumed total reduction in mandatory spending in 2002 (see Table 14). Medicare would be reduced below the current-policy projections by \$71 billion in 2002 and by \$270 billion over the 1996-2002 period. Medicaid savings would equal \$54 billion in 2002 and \$182 billion over seven years. These savings were assigned to the Ways and Means Committee and the Commerce Committee in the House and to the Finance Committee in the Senate.

Other significant reductions in mandatory spending over the 1996-2002 period that were specified in the conference report on the resolution include savings from agricultural programs (\$13 billion), student loan programs (\$10 billion), federal retiree health

benefits (\$5 billion), veterans' benefits (\$6 billion), increased retirement contributions by federal employees or their employing agency (\$4 billion), and additional proceeds from auctions by the Federal Communications Commission of portions of the electromagnetic spectrum (\$14 billion). In addition, the budget resolution assumes substantial savings from various programs as a result of welfare reform legislation, but those savings were not clearly specified by the conference report. The resolution also assumes savings from the sale of assets such as naval petroleum reserves, the United States Enrichment Corporation, and the right to explore for oil and gas on a portion of the Arctic National Wildlife Refuge. Previous budget resolutions have not allowed proceeds from asset sales to count for purposes of deficit reduction, but this year's resolution includes a provision that requires them to be treated as savings for all purposes of the Congressional Budget Act.

The net policy change in revenues included in the budget resolution is very small--just \$1 billion over the 1996-2002 period (see Table 14). As mentioned above, however, the budget resolution provides for a contingent tax cut that is not reflected in the budget resolution's totals. A special procedure established in the resolution, which is discussed in more detail in Box 1, will allow the Congress to consider tax cut provisions as part of the reconciliation bill if the deficit reduction legislation produced in response to the reconciliation directives achieves the level of savings required to balance the budget in 2002. The tax cut is not to exceed \$50 billion in 2002 or \$245 billion in 1996 through 2002. The resolution does not specify any particular changes in tax law, but the conference report indicated that taxes should be reduced on families with children, on two-earner married couples, and on savings and investment.

Because the outlay and revenue levels stated in the budget resolution show a surplus of only about \$6 billion in 2002, simply adding a \$50 billion revenue reduction that is not included in the resolution totals would clearly throw the budget out of balance. However, the resolution assumes that the budget will be balanced in 2002 because the \$50 billion fiscal dividend in that year--which, like the tax cut, was not included in the stated resolution totals--will offset the lost revenues. Since the tax cut may be as large as \$245 billion over the 1996-2002 period and the fiscal

1. The savings are smaller than the \$164 billion in total savings shown in Table 16 because savings from complying with the statutory caps through 1998 are already included in the baseline used as the starting point in Table 14.

Box 1.**Certification of a Balanced Budget and Consideration of the Proposed Tax Cut**

The budget resolution contains special procedures that are intended to allow the Congress to consider a \$245 billion tax cut if the reconciliation legislation is consistent with the resolution and therefore provides enough savings to ensure a balanced budget in 2002. (Reconciliation is the legislative vehicle for achieving the changes in mandatory spending and revenues assumed by the budget resolution.) The procedures are slightly different for the Senate and the House (the Senate provisions are in section 205 of the budget resolution, and the House provisions are in section 210).¹ Both procedures, however, require CBO's certification that enacting the proposed reconciliation legislation would lead to a balanced budget in 2002 (assuming compliance with the discretionary spending levels assumed in the resolution) before the Senate or the House can consider proposals to cut taxes as part of the reconciliation bill.

Procedure in the Senate

Reconciliation instructions included in the budget resolution require Senate committees to submit all of their recommended reconciliation legislation to the Senate Budget Committee by September 22, except that the Finance Committee is not to include the tax cut provisions in the legislation it submits at that time. The Budget Committee then submits the reconciliation package--still excluding the tax cut provisions--to CBO. CBO must estimate whether the savings from the reconciliation legislation would balance the budget in 2002. In making that estimate, CBO is to assume compliance with the discretionary spending limits in the budget resolution unless legislation that supersedes those limits has been enacted. CBO must also use the economic and technical assumptions underlying the resolution in making its estimate. Those assumptions are largely the same as the ones CBO used in developing its April baseline and do not include the effects of the fiscal dividend described in this chapter.

If CBO estimates that the reconciliation savings are at least as great as the budget resolution assumed, it must certify that finding to the Chairman of the Senate Budget Committee, who will then submit the certification to the Senate. The Finance Committee will then submit legislation to implement the tax cut, and the Chairman of the Budget Committee will adjust the budget resolution to reflect the tax cut. The tax cut legislation can then be folded into the reconciliation bill and considered by the Senate.

Section 205 also provides for a similar estimate and certification by CBO when the House/Senate conference

committee has reached agreement on the reconciliation bill. Since the tax cut will presumably be included in the conference report, CBO at that time will have to take the fiscal dividend into account in estimating whether enacting the reconciliation bill would lead to a balanced budget.

In addition to the contingencies included in the procedure described above, section 205 specifies that the entire procedure does not apply unless the reconciliation legislation complies with the sum of the reconciliation directives for the 1996-2002 period and the budget would be in balance in 2002 through 2005.

Procedure in the House

The procedure in the House is slightly different in that the tax cut is to be included in the reconciliation legislation submitted to the Budget Committee on September 22 and subsequently submitted to CBO. As in the Senate's procedure, CBO is to make its estimate assuming compliance with the discretionary spending limits of the budget resolution (unless superseded by law) and using the economic and technical assumptions underlying the budget resolution. Since the reconciliation package that the House submits to CBO is supposed to include the tax cut, however, section 210 specifies that CBO's estimate should reflect the fiscal dividend it published in Table B-4 of the *Analysis of the President's Budgetary Proposals for Fiscal Year 1996*. If CBO determines that the budget would be balanced in 2002 if the legislation was enacted, the Chairman of the House Budget Committee will certify that and will adjust the budget resolution to reflect the tax cut.

If CBO determines that the budget would not be balanced in 2002, the Chairman of the Budget Committee is to notify the Chairman of the Rules Committee. Under section 210, the Rules Committee may recommend a substitute reconciliation bill that would provide the additional savings needed to achieve a balanced budget in 2002. That substitute bill would be submitted to CBO for an estimate to be made on the same basis as the earlier estimate. If CBO determines that the substitute bill would balance the budget in 2002, the Chairman of the Budget Committee would certify that and make appropriate adjustments to the budget resolution.

Section 210 specifies that an objection (point of order) by any Representative can block the initial consideration of the reconciliation bill if the Chairman of the Budget Committee has not certified a balanced budget in 2002, but no such certification is required for House consideration of a conference report. The Rules Committee could, however, recommend a rule waiving the point of order and allowing the House to consider the bill even if a balanced budget has not been certified.

1. As included in the budget resolution, section 205 mistakenly applied to the House as well as the Senate. Under the rule (H.Res. 175) adopted by the House to govern consideration of the budget resolution, section 205 does not apply to the House.

dividend totals only \$170 billion for the seven years, cumulative deficits over the period can be \$75 billion higher than those stated in the resolution. The resolution does not specify how the tax cut should be distributed year by year, however, making it impossible to calculate the yearly deficits that will be projected when both the tax cut and the fiscal dividend are taken into account.

The reductions in spending for discretionary and mandatory programs assumed in the budget resolution will reduce the amount of money the federal government will have to borrow in 1996 through 2002 below the levels assumed in the CBO baseline. That reduction will lower the interest that the federal government must pay on the debt held by the public by \$66 billion in 2002 and by \$181 billion over the 1996-2002 period. Those savings, shown in Table 14, do not include the savings resulting from lower interest rates that are part of the fiscal dividend CBO estimates could result from balancing the budget. Additional interest costs that are not reflected in the budget resolution would be incurred, however, be-

cause of increases in the deficit resulting from tax cuts that exceed the fiscal dividend in 1996 through 2001. Calculating those costs precisely is impossible without knowing the size of the tax cut in each year, but the cumulative deficit increases could push interest costs in 2002 up by several billion dollars. The increase is likely, however, to be less than the \$6 billion budget surplus shown for that year in the budget resolution.

The budget resolution also directs the House Ways and Means Committee and the Senate Finance Committee to include in their reconciliation submissions an increase in the statutory limit on federal debt. The current limit is \$4.9 trillion. As discussed in Chapter 4, debt subject to the limit is likely to reach that level in October or November. The budget resolution calls for an increase in the debt limit to \$5.5 trillion, which will probably be high enough to facilitate necessary borrowing until the end of 1997 if the policies proposed in the budget resolution are enacted.

Table 17.
Change in the Deficit Resulting from the Economic Impacts of Balancing the Budget by 2002
(By fiscal year, in billions of dollars)

	1996	1997	1998	1999	2000	2001	2002	Total, 1996-2000
Change Resulting from Lower Interest Rates								
Outlays (Net interest)	-2	-6	-12	-20	-28	-36	-42	-146
Revenues (Federal Reserve earnings) ^a	<u>b</u>	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>5</u>	<u>20</u>
Subtotal	-2	-5	-10	-17	-24	-31	-37	-126
Change Resulting from Higher Gross Domestic Product (Revenues) ^a	<u>-1</u>	<u>-2</u>	<u>-4</u>	<u>-6</u>	<u>-8</u>	<u>-10</u>	<u>-13</u>	<u>-44</u>
Total Effect on Deficit	-3	-7	-14	-23	-32	-41	-50	-170

SOURCE: Congressional Budget Office.

NOTE: These estimates assume that the budget is balanced by 2002. Outstanding debt depends only on the budget deficit and is unaffected by the changes reflected in this table. Consequently, no further savings in servicing the debt accrue from these changes.

a. Revenue reductions are shown as positive because they increase the deficit.

b. Less than \$500 million.

Economic and Budgetary Implications of Balancing the Budget

Enacting the Congress's plan to balance the budget by 2002 would provide a fiscal dividend by reducing federal interest costs and increasing federal revenues. CBO's April report, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1996*, described those economic implications. The progressive elimination of the federal government's competition for funds in private capital markets would lower interest rates and slightly increase the potential growth of the economy over the next decade.

The path of deficit reduction in the Congressional plan roughly approximates the illustrative path of deficit reduction that CBO assumed in the April report (see Figure 12). At that time, CBO estimated that balancing the budget would yield a fiscal dividend of about \$170 billion over seven years and about \$50 billion in 2002 (see Table 17). Those savings would result from lower interest rates, which would cut the cost of federal payments for interest on the debt, and from greater economic growth, which would boost the tax base and tax revenues. The deficit reductions envisaged by the budget resolution seem likely to yield a similar fiscal dividend.

Balancing the budget over the next seven years will require many hard decisions about taxing and spending policies, and many of those choices will have important implications for the nation's economic outlook. Although the Congress is still working out the details of those decisions, some likely macroeconomic benefits that flow simply from balancing the budget are evident. Growth is likely to be modestly higher, on average, from now until 2002, provided that the policy changes necessary to balance the budget do not fall especially hard on private saving or on productive public investments. Inflation could increase or decrease slightly but should not be much affected. Although the road could be bumpy in the short term, the fiscal restraint implied by the effort to balance the budget need not weaken the economy substantially as long as the Federal Reserve acts

to offset that restraint. Interest rates are likely to be significantly lower, falling to the range that they inhabited in the 1950s and 1960s, when budget deficits were typically modest by today's standards.

The estimates in this chapter reflect only the macroeconomic effects on national saving and investment in an environment in which monetary policy offsets fiscal restraint. The actual outcomes will depend on the fiscal and monetary policy choices that are made. Closing the deficit by means that lead to particularly strong disincentives for private saving or investment, or by reducing productive government investments in infrastructure or education, could undermine the benefits of eliminating the deficit. Moreover, monetary policy that does not accommodate the fiscal restraint inherent in a balanced budget could lead to short-run losses in output--and in incomes as well. Of course, policy choices could also work the other way, by increasing private and public investment. In that case, the nation's economic outlook under a balanced budget would be enhanced.

Although the Congressional plan specifies what will happen only for the next seven years, the course of fiscal policy in subsequent years is also important. (The resolution requires that the budget be balanced in the years 2002 through 2005 in order for the Senate to consider the tax cut anticipated by the resolution.) The growth of health spending and the need to finance the retirement of the baby boomers will put upward pressure on deficits in the years just beyond the current 10-year projection window. Unless that pressure is resisted, the economic benefits of this year's efforts could be reversed.

The Effects of Balancing the Budget

The budget resolution described above lays out targets for fiscal policy--levels of overall revenues, outlays, deficits, and public debt, and more specific targets for broad categories of spending--but legislation is still necessary to implement them. The appropriation bills for 1996, already under way, will begin the process of implementation, but many decisions remain to be made, particularly for the years beyond 1996. The resolution's deficit targets, moreover, give

Table 18.
Potential Economic Impacts of Balancing the Budget by 2002 Compared with
CBO's January Economic Forecast (By calendar year)

	1996	1997	1998	1999	2000	2001	2002
Real Gross National Product							
Percentage change in level from base	0.1	0.2	0.3	0.4	0.6	0.7	0.8
Change in growth rate (Percentage points)	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Real Gross Domestic Product							
Percentage change in level from base	0	0.1	0.2	0.3	0.3	0.4	0.5
Change in growth rate (Percentage points)	0	0.1	0.1	0.1	0.1	0.1	0.1
Interest Rates (Percentage points)							
Three-month Treasury bills	-0.2	-0.4	-0.7	-0.9	-1.1	-1.1	-1.1
Ten-year Treasury notes	-0.2	-0.5	-0.8	-1.1	-1.4	-1.7	-1.7

SOURCE: Congressional Budget Office.

only a rough guide to what deficits will be if the resolution's legislative targets are met, because they reflect neither the fiscal dividend nor any tax cut.

Because of this uncertainty, CBO has not revised its estimates of the fiscal dividend resulting from a balanced budget. The estimates published in April should, however, provide a good approximation of the fiscal dividend that will occur if the budget resolution's plan is implemented. Without considering either tax reductions or the fiscal dividend, the resolution's deficit path is quite close to the illustrative path that CBO used for its April calculations (see Figure 12). Allowing for both a fiscal dividend and a tax cut would probably mean larger deficits in some years, but the differences may not be significant.

Increased Growth

Balancing the budget by 2002 could allow the economy to grow modestly faster--by about 0.1 percentage point a year on average. The annual level of gross national product might be about 0.8 percent higher in 2002 than it would be if fiscal policy continued on its current path (see Table 18).² Moving

to a balanced budget would add to growth by redirecting resources away from public and private consumption and toward investment and an improved national balance sheet--especially by slowing the current pace of borrowing from foreigners and eliminating the need to service that debt.

The increase in national saving that results directly from reducing the deficit is likely to be partially offset by a decrease in private saving. The extent of that decrease is highly uncertain, depending critically on how the deficit is reduced and whether policy changes alter any of the tax factors that enter into decisions to save. Without such changes in taxes, private saving might fall by between 20 percent and 40 percent of the reduction in the deficit, according to the models that CBO has analyzed. Over time, therefore, national wealth would increase by between 60 percent and 80 percent of the cumulative reduction in the deficit.

Some of the rise in national wealth would appear as a higher level of capital stock, thereby increasing productive capacity in the United States, and some would show up as lower levels of borrowing from foreigners. No consensus exists on how much each of those elements would change, but the range of

2. The more familiar concept of gross domestic product measures only production in the United States and does not reflect the decline in debt-service costs paid to foreign lenders. Thus, GNP

could increase by some 0.8 percent in 2002, but GDP might increase by only 0.5 percent.

possible increases in productive capacity over the next seven years is limited. The existing capital stock is large and takes years to change by a noticeable proportion. Moreover, the models that CBO has examined predict that private investment will increase by only about 20 percent of the amount of reduction in the deficit. Such an increase would raise the capital stock by about 2.2 percent in 2002, expanding productive capacity by about 0.5 percent.

The shift of resources to investment and net exports may not go smoothly, however. Balancing the budget implies a substantial amount of restraint overall, averaging some 0.4 percent of GDP each year for seven years. (Fiscal restraint usually lasts for two years or less.) If the Federal Reserve failed to offset that restraint, consumption could fall more quickly than investment and net exports could rise, possibly weakening the economy in the short run. Moreover, even if the Federal Reserve sought to offset fiscal restraint with a more expansionary monetary policy, both the size and timing of the effects of monetary policy on the economy are uncertain. Because a perfect offset would be too much to expect, balancing the budget risks some temporary reduction in real output.

Nevertheless, the danger that balancing the budget as envisaged by the budget resolution would on its own precipitate a substantial downturn seems small, provided that changes in spending and taxes follow a relatively smooth path and are credible to both financial markets and the Federal Reserve. Given such credibility, long-term interest rates are likely to fall and help boost domestic investment, and the Federal Reserve could act early to reduce short-term rates. The annual amount of restraint, moreover, seems manageable if deficit reduction follows a reasonably smooth course. Any short-term problems that might occur should not interfere with the investment and gains in productivity that would bring increased growth between now and 2002.

Lower Interest Rates

Economists disagree widely over the effect of fiscal policy on interest rates. Some believe that the openness of U.S. capital markets ensures that real rates cannot stray far from those in other countries, and

thus they would give little credence to any fiscally induced change in real rates. Others, using models of the U.S. economy alone, cite much larger impacts: according to one of those models, balancing the budget could reduce long-term interest rates by as much as 400 basis points (4 percentage points).

Good arguments exist for a smaller reduction in long-term rates--between 100 and 200 basis points. That narrower range encompasses the uncertainty about the likely effects of balancing the budget. A drop of that magnitude from CBO's baseline forecast would leave real long-term rates at between 1 percent and 2 percent--lower than they have been since the 1950s--and real short-term rates close to zero. During the 1970s, short-term rates fell below the rate of inflation largely because of unanticipated increases in inflation and inappropriately expansionary monetary policy. But in periods without such policy mistakes, real short-term interest rates have rarely been as low as zero.

How quickly rates would fall depends on many poorly understood factors, but the drop in rates would probably anticipate actual deficit reduction by a year or so. Long-term interest rates, for example, might respond to announced future reductions in the deficit if those reductions seemed credible, and credibility would be likely to increase as the Congress proceeded along the path of deficit reduction. The timing of a drop in short-term rates would depend on when the Federal Reserve acted, which--given the long lags in the effect of monetary policy on the economy--could also anticipate the actual decline in the deficit. CBO has assumed, relatively conservatively, that the decline in both long- and short-term rates might occur over a five- to six-year period. Some analysts might argue that long-term rates could respond even faster, as they did after enactment of the Omnibus Budget Reconciliation Act of 1993. But the evidence on the cause of that drop is mixed: the sharp decline in long-term rates in 1993 could also be attributed to falling expectations about inflation, and in any case the decline was partly reversed within a year. Moreover, long-term rates did not fall quickly following enactment of a similar fiscal package in 1990. With such conflicting evidence, some caution about the likely speed of reductions in interest rates seems warranted.

Narrowing the range any further than 100 to 200 basis points proves difficult.³ CBO's estimates in Table 18 split that range, since they imply that a weighted average of interest rates would drop by 150 basis points over six years. (The weights are 25 percent on short-term rates and 75 percent on long-term rates and roughly reflect the shares of short- and long-term securities in current federal borrowing from the public.) Long-term rates drop more than short-term ones, on the assumption that the policies undertaken to balance the budget will put the long-term fiscal outlook on a more sustainable path than is possible under current policies.

The Uncertainty of the Economic Estimates

The economic estimates are subject to several risks. First, there is substantial uncertainty about how balancing the budget directly affects capital markets and

growth. Second, the policy changes needed to implement the budget resolution will themselves affect the workings of the economy, sometimes in hard-to-predict ways. A third uncertainty arises because many things will happen--not just in the area of fiscal policy but in the rest of the economy--that may not be anticipated in the budget resolution's economic assumptions. CBO's current economic assumptions, described in Chapter 1, reflect economic data as of early July and already differ from those of the budget resolution, which are based on a forecast that CBO made at the end of 1994. Although the differences have little effect on the budget in 2002, they illustrate the imperfection of forecasts (see Appendix A).

Changes in the economy that are unrelated to fiscal policy could easily obscure the effects on growth and interest rates that balancing the budget would set in motion. For example, if inflation threatens to rise, the Federal Reserve might be unwilling to lower short-term interest rates as quickly as the budget-balancing scenario assumes. The estimates in Table 18 should therefore be viewed with appropriate caution: a few years down the road, it may be impossible to disentangle the effects of balancing the budget from other forces operating at the same time in the U.S. economy.

3. See Appendix B in Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1996* (April 1995).

